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Special Reviews: Behavioral Economics for Sociological Purposes

Richard H. Thaler – Cass R. Sunstein:
Nudge: Improving Decisions about Health, Wealth, and Happiness
New Haven 2008: Yale University Press, 293 pp.

Richard Thaler, an economist at the University of Chicago's School of Business, is one of the founders of modern behavioural economics, along with the economists Amos Tversky and Daniel Kahneman. Cass Sunstein is a legal scholar at Harvard University and has been at the forefront of applying the results of experimental economics to social problems, especially in the field of law. This book has one 'big idea', and it is a very important one. The idea is called 'status quo bias', meaning that in many choice situations people value the status quo (what they currently have) and will forego the opportunity to switch to an alternative unless the alternative is significantly more attractive than the status quo. In situations where it is difficult to evaluate the exact benefits and costs of what one has over what one could only obtain with some conscious effort, people will tend to stick with what they have. For example, in the United States, the default condition with respect to organ donation is 'no donation', so if people want to donate their organs when they die, they must explicitly state this preference. In France, the default condition is 'donation', and an individual who does not agree with this default condition must expressly indicate their desire not to donate. Consequently, the rate of organ donation is France is several times higher than it is in the United States.

While policies that exploit the status quo bias may be called 'paternalistic', they cannot be said to violate individual rights, and in a democracy, for most individuals, many may be termed 'self-disciplining'. For instance, by law a little bell rings incessantly in my car whenever anyone fails to attach their seatbelt. I can easily disable this bell, but I welcome it as an aid in overcoming my inertia in the enforcement of automobile safety procedures. The idea behind *Nudge* is that the choice of a default condition can both allow individuals to choose as they please in a democratic market society, while at the same time improving social outcomes by providing default conditions that lead to socially useful choices. Thaler and Sunstein call this 'libertarian paternalism'. While one might think that this sort of minimal market intervention can have only a limited impact on social outcomes, the organ donation example suggests otherwise. Perhaps the most important policy of this type would be a mandate that employers make contributions to retirement savings, in the form of 401(k) or other plans, which would be the default, so that individuals who do not wish to save would have to register the desire to opt out of the plans. A related idea developed in the book is that employees commit to saving a certain fraction of future raises they are awarded by employers, the idea being that people do not want to reduce their 'status quo' income in order to save, but they may be willing to accept a new, lower 'status quo' when the status quo changes.

This is a very sensible idea. The justification of the assumption that one default condition is preferable to another is generally the assertion that individuals are systematically prone to overstate the value of immediate gratification and understate the value of future pay-offs. This is often called 'hyperbolic discounting' in the literature, but the real issue is excessive present-orientation, which can occur just as easily with exponential, time-consistent preferences, as with hyperbolic, time-inconsistent preferences. For instance, making retirement saving the default arrangement can serve to counter the tendency to under-save, which is itself a response to the overvaluation of current as compared to retirement consumption. A second justification is the tendency for individuals to ignore low probability events, such as having an automobile accident. I consider the irritating bell that sounds in my car to be a present pain that offsets the present pain of fastening my seatbelt, given that I cannot really experience the pain of great bodily injury with an infinitesimal probability 0.00001.

A second sort of libertarian paternalism takes the form of having the government require that firms reveal with clarity and salience the full terms of a contractual agreement with consumers. For instance, it might be required that a restaurant print the nutritional content of its food on the menu, or that the precise interest rate on a mortgage be posted, or that all of a broker's charges be itemised on a monthly statement. These measures are 'paternalistic', because if consumers were fully aware of the situation, they might demand this information from firms, and market competition would then lead to compliance. The role of the government in this situation would then be the more traditional one of enforcing 'truth in advertising' – firms are not allowed to misrepresent their offerings. This form of social policy may also not really be paternalistic. If the transaction costs are high enough, I might tolerate the restaurant's practice of not revealing nutritional content, even though I would be willing to pay to have this information revealed, but I would not be willing to pay to offset the restaurant's revenue loss because I eat smaller portions of healthier food. If my unwillingness to pay is due to my excessive present-orientation, and if I recognise this, I prefer the government regulation for myself.

Thaler and Sunstein, like other behavioural economic policy analysts, are widely criticised for their paternalism, which flies in the face of free-market ideology. While some suspicion is warranted, the idea of a market economy with no governmental correctives is just a libertarian fantasy that people neither want nor with which they could comfortably live. Policies of the sort discussed in this volume are a welcome addition to the policy-maker's toolbox. Libertarian paternalism, of course, is not a panacea. It will not replace the price system as the central mechanism for allocating goods and services, and it will not obviate the need for legislation that corrects market failures, such as the tendency for excessive energy use to undermine the natural environment, and perhaps even partially offsets such 'human frailties' as the tendency to under-save and abuse illegal substances. However, libertarian paternalism is attractive as a first line of attack on even these problems and should be part of the policy-maker's toolkit.

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George Loewenstein: *Exotic Preferences: Behavioural Economics and Human Motivation*
Oxford 2008: Oxford University Press, 671 pp.

Behavioural economics, the marriage of insights from psychology and economics, has matured from a fringe interest of a small handful of researchers towards ac-